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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before The
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992	)	MM Docket No. 93-215
	)	
Rate Regulation	)	

JOINT REPLY COMMENTS OF BELL ATLANTIC,
THE NYNEX TELEPHONE COMPANIES,
AND THE PACIFIC COMPANIES
<u>IN RESPONSE TO NOTICE OF PROPOSED RULEMAKING</u>

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List A B C D E

TABLE OF CONTENTS

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1. Introduction and Summary

The cable industry continues its efforts to block or delay any meaningful regulation of its rates, while seeking preferential treatment under any rules that ultimately are adopted in order to obtain an artificial advantage in its increasing competition with the regulated telephone industry. For example, as the Commission itself has recognized, price caps have many advantages over traditional cost-of-service regulation; they should apply to all cable operators regardless of how initial rates are set. At every turn, however, the

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[1] The Bell Atlantic telephone companies ("Bell Atlantic") are The Bell Telephone Company of Pennsylvania, the four Chesapeake and Potomac telephone companies, The Diamond State Telephone Company, and New Jersey Bell Telephone Company.

[2] The NYNEX Telephone Companies include New England Telephone and Telegraph Company and New York Telephone Company.

[3] The Pacific Companies are Pacific Telesis Group, Pacific Bell, and Nevada Bell.

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cable industry asks the Commission to establish price cap rules for cable that would give it preferential treatment compared to telephone companies. This would translate directly into an artificial competitive advantage in the marketplace.

The cable industry has taken the same tack with respect to the Commission's rules for setting reasonable rates before price caps are imposed. For example, the Commission's decision to include low penetration systems in its benchmark calculation means that cable rates will be presumed reasonable under the Commission's rules even if significantly higher than rates charged by systems subject to genuine head-to-head competition. In response to the implementation of those rules -- and in defiance of both the Commission's objectives and the Congressional intent -- the cable industry has actually increased its already excessive rates for many consumers, effectively treating the 1992 Cable Act as an excuse to reap further monopoly gains.[4] A notable exception is the city of Alexandria, Va., where the local cable operator -- facing the prospect of head-to-head competition with the local telephone company -- has actually decreased its rates by more than 10 percent.[5] In the absence of the prospect of competitive entry, however, numerous cable operators have raised their

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[4] See, e.g, Singletary, Most Area Cable TV Rates Rise Today Under New Rules, Washington Post at A1 (Sept. 1, 1993); Zurawik, Cable TV Rate Relief Spelled I-N-C-R-E-A-S-E, Baltimore Sun at 1A (Aug. 26, 1993).

[5] See Hong, Cable Rates Drop in Alexandria, Washington Post at V1 (Sept. 9, 1993).

rates and actually blamed the Commission's benchmarks for this most recent round of price hikes.

Even these latest increases are not enough for the cable industry. Cable now asks the Commission to adopt cost-of-service rules -- designed to function exclusively as a backup option for a limited number of cable operators seeking to justify rates above even the inflated benchmark -- that will produce still further rate increases by large segments of the monopoly cable industry. Cable suggests that meaningful cost-of-service regulation will somehow inflict grave financial injury upon it, but in fact a recent study by independent analysts concluded that regulation will have a minimal impact on the financial success of the cable industry.[6]

The real danger, if cable has its way in this proceeding, is that the Commission's cost-of-service rules will open up additional avenues for cable operators to continue exercising the very market power that Congress sought to extinguish. It would do so, for example, by inflating cable's rate base through inclusion of acquisition cost premiums that are attributable to the expectation of continued monopoly rents, by authorizing depreciation rates that substantially exceed those permitted for telcos, and by authorizing excessive

[6] "[W]ith operating cash flow margins above 40 percent, cable system operators should remain highly profitable." The Veronis, Suhler & Associates Communications Industry Forecast 109 (July 1993). In fact, according to this analysis, cable revenues overall will continue to grow following the implementation of the Commission's regulations at a compound annual rate of 7.2%. Id. at 116. This forecast makes cable's dire predictions particularly difficult to credit.

rates of return, including returns on equity of 35 percent or more.

Under cable's approach, moreover, the Commission's rules would arm the cable industry with artificial regulatory preferences that it could wield to the disadvantage of its competitors in local telephony. Although the focus here is on the rates of cable operators, the Commission cannot properly conduct this proceeding in a vacuum. In the real world, the development of fiber optic and other innovative technologies now permits the transmission of voice and video signals over the same facilities.[7] There is no longer any question that the deployment of these new technologies has triggered a rapid convergence of the cable and telephone industries and that the two industries increasingly compete head-to-head,[8] particularly in local telephony where cable has been able to fund its ventures with revenues extracted from captive cable

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[7] The accompanying affidavit of Dr. Edward A. Walvick summarizes the evolution and rapid convergence of telephone and video access technologies. See also Huber, Kellogg, and Thorne, The Geodesic Network II: 1993 Report on Competition in the Telephone Industry at 2.53-2.67 (1992) (a copy of the relevant pages is attached hereto).

[8] As the Commission correctly observed, "in the near future, telephone services, personal communications services (PCS), transport, and other telecommunications services may be offered by cable operators." Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992, Rate Regulation, MM Docket No. 93-215, Notice of Proposed Rulemaking, at ¶ 59 (rel. July 16, 1993) (NPRM). See also id. ¶ 85 n.99 (equivalent productivity offset necessary to "harmonize incentives for converging technologies"). Cable itself readily acknowledges that the two industries are rapidly converging. See, e.g., Comments of the Medium-Sized Operators Group (Medium-Sized Operators) at 28; Comments of California Cable TV Association (CCTA) at 75-77; Comments of Cable Operators and Associations (Cable Operators) at ii, 8.

customers. Because the Commission's rules for cable will necessarily affect both industries, it must shape those rules with an eye to competitive parity. Equivalent treatment is essential to ensure that the most efficient firms, rather than those with special regulatory advantages, prevail in the marketplace.

We believe that the Commission should substantially streamline or eliminate many of the restrictive and outmoded rules that currently apply to telephone companies. Indeed, we would endorse some of the rules proposed by cable in this proceeding -- such as the adoption of a pure price cap regime -- if the Commission were to accord comparable flexibility to telcos. Until the Commission takes that step, however, it must avoid tipping the competitive balance by treating one industry more favorably than the other. Consequently, except where specific departures can be justified because of demonstrable differences between the two industries -- and none have been shown here -- the Commission's cable rules should closely parallel those currently applicable to telcos.

There are other reasons to avoid unwarranted deviations from the telco model. The Commission's telco rules have been developed and refined over many years and embody a wealth of administrative experience. It would be unreasonable to start from scratch in framing rules to deal with identical issues for a comparable and rival industry. To ensure that the Commission and thousands of local franchising authorities are equipped to regulate cable consistently and coherently, it obviously makes good practical sense to adopt uniform and familiar rules with a discernible record of administrative application.

The cable industry has already succeeded in derailing a truly competitive benchmark rate. The Commission should reject its further efforts to block or delay meaningful cost-of-service rules as well. A workable and comprehensive price cap system for rate adjustments can deliver efficient and fair regulation without unduly burdening the Commission, so long as it is built on reasonable and equitable initial rates. A cost-of-service option is needed to deal with those few instances where the initial benchmark does not afford a fair rate of return, but that option must be administered in a meaningful way. Otherwise, cable will be able to expand a small outlet designed to govern exceptional circumstances into a gaping loophole that will overwhelm the benchmark and price cap regime -- and thereby defeat Congress's goal to free consumers from unreasonably high cable rates.

2. The Commission Should Impose Uniform Accounting, Cost-Allocation, and Affiliate-Transaction Rules Equivalent to Those for Telcos

The Commission must ensure that cable companies do not unfairly shift the costs of their telephone and other lines of business onto their captive cable subscribers. To achieve that goal, the Commission and local franchising authorities must be able to examine the manner in which cable operators allocate common costs among different lines of business and account for transactions between affiliates. If creative accounting is used to shift costs of telephone or other services to cable operations, the rate of return approved by the Commission will cause cable subscribers to pay higher rates than they should, with the inflated revenues available to subsidize cable's other businesses. Such cross-subsidization would be an abuse of cable's market power, would facilitate unfair competition in cable's other lines of business, and would operate to the ultimate detriment of consumers.

The solution to these concerns is a system of uniform cost and accounting standards. In the words of one group of cable commenters, "[c]ost allocation and accounting rules are necessary components of a sound cost-of-service rate regulatory regime."[9] Cable's repeated emphasis on the purported heterogeneity of the industry only accentuates the need for uniform accounting rules.[10] Unless the relevant financial information is compiled in a consistent manner, regulators will be unable to conduct a meaningful examination of cost submissions -- which will prevent them from fulfilling their statutory responsibility to ensure reasonable cable rates and to prevent cross-subsidization.

The Commission should apply to cable the same basic accounting, cost-allocation, and affiliate-transaction rules

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[9] Comments of Cablevision Industries Corporation, _et al._ (Cablevision Industries) at 48. _See also_ Comments of Time Warner Entertainment Company, L.P. (TWE) at 37; CCTA at 69.

[10] Comments of the National Cable Television Association (NCTA) at 28; Comments of Tele-Communications, Inc. (TCI) at 57.

that govern telcos. Parity of treatment will promote fair competition between these converging industries. Using the telco rules as a model, moreover, is both efficient and sensible because the Commission has already found those rules to be effective in preventing cross-subsidization in the telephone industry. Imposing the same rules here will provide consumers and competitors in the cable industry with the kind of protection that they currently enjoy in the telephone area.

Unable to raise any legitimate objection to the establishment of accounting and cost-allocation rules, cable retreats to its recurring theme of delay. Cable argues that the Commission needs further study and experience with the cable industry before it can promulgate appropriate rules.[11] The Commission should reject this unjustified effort to postpone, and undermine, effective oversight of the Commission's rate regulation rules for cable. Proper accounting rules must be put in place now so that regulators can act promptly to establish initial rates that both are reasonable and do not permit cable companies to subsidize the competitive telephone services that they increasingly provide. The existing rules that govern telcos provide a ready model, and there is no reason why those rules cannot effectively be applied to cable without delay.

Even if one assumes that, with additional experience, the Commission could develop rules more narrowly tailored to

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[11] NCTA at 28; TWE at 20-21; TCI at 51, 56; Cable Operators at 88.

the cable industry, that would not justify deferring action on such rules now. Delay will seriously impede achievement of the statutory objectives, with no attendant benefit. The Commission can always modify and improve accounting and cost-allocation rules for both industries in the future. But neither the Commission nor local regulators can conduct meaningful proceedings in the absence of uniform accounting and allocation rules. If ratemaking proceedings are conducted before the Commission implements uniform standards, the resulting rate determinations will rest on an unreliable foundation. The consequence in many cases will be approval of excessive rates in derogation of the Commission's statutory responsibilities.

The Commission also should promptly implement affiliate-transaction rules similar to those applicable to telcos.[12] Some cable companies argue that the Commission should defer implementation until there is evidence that cable is abusing affiliate transactions,[13] but that argument is specious. These are not remedial rules intended to punish misbehavior. Rather, they are designed to ensure that excessive payments to affiliates are not used to justify the imposition of excessive rates on cable subscribers. The need for reliable oversight of affiliate transactions has been further heightened now that the Commission has ruled that all

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[12] Most cable commenters have not opposed adoption of affiliate-transaction rules, and some have expressly endorsed such rules. See, e.g., TWE at 39-40; TCI at 59.

[13] See, e.g., NCTA at 42; Cablevision Industries at 58.

programming costs paid to affiliates are exogenous, which would allow cable to shift its monopoly profits upstream by paying inflated prices to its programming affiliates.

The threat that cable will force its subscribers to subsidize other lines of business is both real and immediate. Cable's comments in this proceeding candidly acknowledge that cable operators are upgrading their systems to provide telephone and other advanced services, not just cable service.[14] So long as they are not covered by the cost-allocation and affiliate-transaction safeguards that apply to telcos, cable companies are free to use revenues extracted from their captive cable customers to pay for the improvements needed to provide telephone service and, in some cases, to provide that service for free.[15]

Cable's request to delay the implementation of cost-allocation rules is a transparent effort to preserve its existing competitive advantage. Indeed, while imploring the Commission to take no action on the cable front, cable seeks to increase the disparity in regulatory treatment by arguing elsewhere for the imposition of even more stringent accounting

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14 See NCTA at 26 (cable companies have been replacing coaxial cable with fiber to perform "non-video functions").

15 Comments of Media General Cable of Fairfax County, Inc. at 5 (system currently offering "an intra-county telephone and data network provided free of charge to the local government").

rules on telephone companies.[16] The Commission should not countenance these efforts, but instead should safeguard cable subscribers and promote fair competition by subjecting cable operators to the same accounting standards that govern telcos.[17]

3. **The Cost-of-Service Rules for Cable Should Parallel Those Historically Applied to Telephone Companies**

Cable offers more of the same on cost-of-service issues. It asks the Commission to turn its back on a century of regulatory precedent and to grant preferential treatment to

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[16] See Joint Petition of NCTA and CFA, Amendments of Parts 32, 36, 61, 64, and 69 of the Commission's Rules, RM 8221 (filed April 8, 1993). This argument flies in the face of the Commission's repeated conclusion that its existing rules for telephone companies provide abundant protection for consumers and competitors alike. See Video Dialtone Order, 7 FCC Rcd 5781, 5788 ("our existing regulatory safeguards will . . . effectively guard against anticompetitive behavior by telephone companies in the video marketplace"); id. at 5827 ("[w]e conclude that existing safeguards against discrimination and cross-subsidization in the provision of basic services . . . should effectively protect against potential anticompetitive conduct by local telephone companies providing video dialtone"); The Chesapeake and Potomac Tel. Co. of Va., W-P-C-6834, Order and Auth. 8-10 (rel. Mar. 25, 1993) ("we believe that our existing safeguards . . . are adequate to protect against anticompetitive conduct by C&P").

[17] In addition, cable companies seeking to provide telephone service must, to the same extent as telcos, file tariffs supported by cost justifications and must also be required to seek authority under section 214 before constructing, operating, or acquiring interstate lines of communications. The Communications Act provides no basis for treating cable companies differently than telcos in these respects. See 47 U.S.C. § 203(c) ("No carrier . . . shall engage or participate in such communication unless schedules have been filed and published . . . ."); 47 U.S.C. § 214(a) ("No carrier shall undertake the construction of a new line or of an extension of any line, or shall acquire or operate any line . . . until there shall first have been obtained from the Commission a certificate . . . ."); see also American Tel. & Tel. Co. v. FCC, 978 F.2d 727, 735-36 (D.C. Cir. 1992).

the cable industry by adopting rules calculated to encourage further rate increases above even today's inflated levels. Cable advances no valid reason to depart from the time-tested rules historically applied to the telephone industry, and the Commission should reject its plea for special preferences.

a. Cable ratebase should be limited to the net original construction cost of assets used to provide regulated cable service.

Cable's plant should be valued at the original construction cost, net of depreciation, of the assets used to provide regulated cable service. There is nothing about the cable industry that would justify a departure from that sound and commonly used standard -- on the contrary, cable's proposal to use a current market value standard would saddle ratepayers with wholly inappropriate costs and would impermissibly perpetuate cable's exercise of market power.

It is nonsensical to characterize an original cost standard as "draconian" and "confiscatory."[18] Original cost is the standard commonly used by both state and federal regulators for a variety of regulated industries.[19] It is

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18 NCTA at 4-5, 7.

19 As of 1991, no less than 44 state regulatory commissions used the original cost method for regulating the rates of electric, gas, and telephone companies. See Phillips, The Regulation of Public Utilities 338 (1993).

also both favored as a matter of economic theory[20] and thoroughly established as a matter of law.[21] There is certainly no reason to view a ratemaking methodology so widely accepted as the proper standard for other industries as punitive or inapt when applied to the cable industry.[22]

Nor is there any basis for cable's nearly universal contention that the Commission must apply a present market value standard in order to ease the transition from an unregulated to a regulated environment.[23] After Congress adopted the Natural Gas Act of 1938, pipelines advanced essentially the same argument, asserting that the FPC was required to include in their ratebase their "going concern"

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[20] See, e.g., Phillips, supra, at 337: "The use of an original cost rate base enables public utilities to maintain their credit standing and to attract new capital. Investors receive a rate of return on the money that they have invested in the utility." Indeed, "an original cost rate base serves this purpose better than one based upon reproduction cost." Id.

[21] See, e.g., Duquesne Light Co. v. Barasch, 488 U.S. 299, 308-10 (1989); FPC v. Hope Natural Gas Co., 320 U.S. 591, 596-97, 605 (1944); Jersey Central Power & Light Co. v. FERC, 810 F.2d 1168, 1175 (D.C. Cir. 1987) (en banc).

[22] There is absolutely no merit to cable's contention that Bluefield Waterworks & Improvement Co. v. Public Service Comm'n, 262 U.S. 679 (1923), and McCardle v. Indianapolis Water Co., 272 U.S. 400 (1926), require the Commission to use present market value rather than original cost. See Medium-Sized Operators at 6-7; Comments of Continental Cablevision, Inc. (Continental) at 26-27. The principles underlying the cited portions of Bluefield and McCardle were repudiated in Hope Natural Gas. The Court there abandoned the "fair-value" doctrine on which Bluefield and McCardle had been predicated.

[23] NCTA at 10-17; TCI at 21; Comments of Comcast Cable Communications, Inc. (Comcast) at 23-30; Comments of Viacom International, Inc. (Viacom) at 14-16; Continental at 28-29; Cable Operators at 14-22, 53; Medium-Sized Operators at 6-8; Cablevision Industries at 9-12.

values built up prior to enactment of the legislation. The Supreme Court rejected the argument, holding that those intangible values should not be capitalized in ratebase.[24] No different result is warranted here.

Cable argues that the industry has failed to keep adequate records of the original construction cost of its plant and should therefore be allowed to use different -- and inevitably higher -- values for its systems.[25] In the first place, these claims are difficult to credit. Cable operators, no less than other businesses, must maintain accurate records for tax, financial accounting, and other purposes -- indeed, they must do so simply as a matter of prudent business practices. The Commission should view skeptically assertions that depict the relatively young cable industry as uniquely incapable of reconstructing the original cost of its systems. But more fundamentally, even assuming that cable operators were not technically subject to record-keeping requirements, cable subscribers should not be forced to pay higher rates simply

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[24] See FPC v. Natural Gas Pipeline Co., 315 U.S. 575, 591-92 (1942). Likewise, in Hope Natural Gas, the pipeline company argued that, in its inaugural cost-of-service proceeding under the Natural Gas Act, it was entitled to include in its ratebase the reproduction cost of its assets, measured under a "trended original cost" methodology (320 U.S. at 596-97) -- a concept similarly embraced in this proceeding by some cable operators. See Viacom at 39-42. The Court rejected that approach and approved instead the FPC's "actual legitimate cost" standard. 315 U.S. at 596, 605. Accord Colorado Interstate Gas Co. v. FPC, 324 U.S. 581, 604-05 (1945) (holding that Commission correctly used original cost approach in cost-of-service proceeding following passage of Natural Gas Act).

[25] NCTA at 10; TCI at 17; TWE at 29; Continental at 41; Cable Operators at 65.

because the industry failed to keep adequate accounting records.

Nor should the Commission discard the original-cost methodology merely because, in an occasional case, the original owner's costs might be difficult to prove. If evidentiary problems arise in individual cases, the Commission and local franchising authorities are amply empowered to construct reasonable regulatory solutions -- including presumptions, comparisons, and estimates. Hypothetical difficulties of proof do not justify discarding a conceptually sound ratebase methodology that is required to protect cable consumers from unreasonable rates.

Cable argues that the original cost standard fails to take into account operating losses that some cable systems incurred prior to rate regulation with the expectation that those losses would be recovered in later years.[26] They insist that, if the Commission uses original cost rather than current market value, it "must allow inclusion of operating losses in the rate base."[27] The argument is wholly without merit. As the D.C. Circuit stated in response to a similar assertion, "one proposal for rate-base inclusion that has met with almost uniform rejection across more than half a century of Supreme Court precedent . . . is the notion that the losses of a utility sustained in previous years must be capitalized into a rate base so that the payments of utility users in future years

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[26] NCTA at 11.

[27] Id.

can help alleviate the earlier deficiencies."[28] Cable ratepayers should not be forced to reimburse operators for losses that are not reflected in the property devoted to the regulated cable service.[29]

The Commission must also exclude from ratebase cable's excess acquisition costs. First, as Congress determined in adopting the 1992 Cable Act, these costs are largely a reflection of anticipated monopoly profits.[30] Permitting cable ratebase to be contaminated by such costs would effectively nullify the central statutory objective by building permanently into cable's rate structure the fruits of

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[28] Communications Satellite Corp. v. FCC, 611 F.2d 883, 892 (D.C. Cir. 1977). See also FPC v. Tennessee Gas Transmission Co., 371 U.S. 145, 152 (1962); FPC v. Natural Gas Pipeline Co., 315 U.S. at 590; Galveston Elec. Co. v. Galveston, 258 U.S. 388, 395 (1922).

[29] Permitting the capitalization of operating losses "would unfairly privilege the ratepayers of previous years at the expense of ratepayers of future years. One or the other must bear the loss, and in the mandate that rates be reasonable there is no justification for shifting that burden." Communications Satellite Corp. v. FCC, 611 F.2d at 894.

[30] See S. Rep. No. 92, 102d Cong., 1st Sess. 8-10 (1991). As noted in our opening comments, Congress relied on testimony by a major cable operator acknowledging that acquisition premiums are the product of anticipated monopoly profits. See id. at 9. Even in this proceeding, some cable operators admit that at least a portion of these costs reflect the expectation of monopoly rents. E.g., Viacom at 36-39. It is illogical, however, to assume, as Viacom does, that the reduction in cable stock market valuations following adoption of the 1992 Cable Act can be used to quantify the extent of the monopoly premium. See id. at 37-38. The fact that stock prices may move in response to actions taken by Congress or the Commission tells us nothing more than how the market values the effect of those actions. It certainly cannot provide useful guidance on the extent of monopoly premiums in excess acquisition costs, especially when the Commission has not yet taken steps to eliminate the effect of those premiums from cable rates.

its market power. This would also reward operators who engaged in profiteering transactions by trafficking in cable systems -- the very practice that Congress directed the Commission to prevent.[31]

Second, even if a portion of excess acquisition costs are attributable to intangible values other than the expectation of monopoly profits, it does not follow that those values should be included in ratebase. Cable subscribers should be required to pay only for capital devoted to regulated cable service. That a company may have acquired cable assets at a premium because of goodwill or other intangibles does not justify a higher rate than the original owner could have charged based on the capital committed to the regulated service.[32] Surely Congress did not intend cable subscribers to suffer higher rates merely because the ownership of their system may have changed hands.[33] In fact, the legislative history points in precisely the opposite direction -- one of the motivating concerns behind the legislation was Congress's

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[31] See H.R. Rep. No. 628, 102d Cong., 2d Sess. 119 (1992) (Congress's purpose in enacting the anti-trafficking provisions of the 1992 Act was to prevent "profiteering" transactions that adversely affect cable television rates).

[32] Intangibles such as goodwill, franchise value, going concern value, and the like are routinely excluded from regulated ratebase because they do not reflect the capital invested in assets actually used in providing the regulated service. See Phillips, supra, at 350-53.

[33] Presumably, subscribers already paid to cover the costs incurred by the original owner in creating the goodwill and other intangibles. Reflecting those costs in an inflated post-acquisition ratebase would effectively make subscribers pay twice for the same expenses.

strong disapproval of exorbitant acquisition premiums and the consequent rate spikes experienced by consumers.[34]

Nor is it relevant whether acquiring companies that incurred excess acquisition costs acted "prudently." Imprudency is not the basis on which such costs are excluded -- even if prudently incurred, those costs have no place in cable ratebase because they do not reflect capital devoted to regulated cable service.

These acquisition premiums cannot be justified by the cable industry's broad assertion that acquisitions to consolidate or "cluster" ownership of systems produces efficiencies that benefit cable subscribers.[35] On the contrary, where these premiums are relied upon as the basis for further increasing cable rates, they harm rather than benefit subscribers.[36]

Finally, cable's assertions that excess acquisition costs must be included to avoid damaging the cable industry or discouraging beneficial acquisitions[37] are entirely

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[34] See S. Rep. No. 92, supra, at 8-10.

[35] E.g., TCI at 18.

[36] Moreover, even under cable's own argument, these "benefits" could not justify any different ratebase treatment unless they actually reduced costs by more than the monopoly premium paid in acquiring the system. As a result, even if cable were right, the presumption must still be that any premiums are excluded from ratebase and can only be included where a cable operator can prove that any benefits to its subscribers that result from the acquisition exceeded the premium paid.

[37] NCTA at 14-16; Comments of Cablevision Systems Corporation (Cablevision Systems) at 20-22; Cablevision Industries at 24.

speculative and in any event cannot justify forcing cable subscribers to bear the financial burden of cable's corporate acquisition policies.[38] Cable is free to recoup its acquisition costs from its other services, but it must not be allowed to build those costs into its regulated ratebase.

b. The Commission should establish a uniform rate of return to ease the administrative burdens on regulators and cable operators alike.

As it has proposed to do, the Commission should adopt an industry-wide rate of return for cable. Even some cable operators support this proposal,[39] properly recognizing that any other approach will unduly burden regulators and cable operators alike. A uniform standard set at an appropriate level will provide the industry with adequate earnings and, at the same time, free the Commission and local franchising authorities from the arduous task of establishing individualized rates of return for each operator.[40]

The cable companies opposing uniformity say that the industry's purported heterogeneity forecloses adoption of a

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[38] Also, as the Commission itself has recognized, permitting excess acquisition costs to be included in ratebase would give cable operators an incentive to "manipulate" acquisition prices in order to "inflate" their ratebase. See Ratebase Order, 3 FCC Rcd 269, 273 (1987).

[39] Viacom at 43; Cablevision Industries at 38; Continental at 58.

[40] The regulatory burden would be complicated further by the fact that the Commission and local franchising authorities will be responsible for regulating different tiers of service. That raises the prospect that the same operator could have a different rate of return for each tier, creating wholly unnecessary complexities.

single return rate.[41] But it is well established that ratemaking agencies have wide latitude to adopt uniform rates of return to govern broad classifications of suppliers.[42] Particularly where "administrative burdens" preclude an individualized approach, the Commission acts well within its discretion by adopting industry-wide standards.[43]

Nor must the Commission, as some cable companies suggest, boost the rate of return in individual cases to account for the vagaries of certain operators' business situations.[44] The Supreme Court has long recognized that "high cost operators" -- including those with a high cost of capital -- "may be more seriously affected by price controls than others."[45] To the extent that an operator's actual investments in regulated cable service exceed the industry average, it will earn the industry-wide rate of return based on that higher ratebase. Nothing more is required.

Nonetheless, for the reasons discussed below, should the Commission determine to set different rates of return for

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[41] NCTA at 20-22; TCI at 37-44; TWE at 33-34; Comcast at 37-38; Comments of Tele-Media Corporation (Tele-Media) at 16-17.

[42] See, e.g., Permian Basin Area Rate Cases, 390 U.S. 747, 777, 808 (1968). In Permian, the Supreme Court approved the adoption of uniform ceiling prices -- based on average expense and investment figures and a uniform rate of return -- for large groups of natural gas producers in various production areas.

[43] Id. at 757.

[44] TCI at 40; TWE at 17-18; Cablevision Systems at 34.

[45] Bowles v. Willingham, 321 U.S. 503, 518 (1944).

individual cable operators or for particular groups of cable operators, it should do so based on the actual capital structure and actual cost of debt of those individual operators or groups of operators.

c. The Commission should set cable's rate of return in the same manner historically used for telcos, and it should use cable's actual capital structure.

In every possible way, cable seeks a rate of return that will produce higher rates for subscribers, that will give it an unfair competitive advantage in the marketplace, and that would convert the cost-of-service safety valve into an avenue for continued exercise of market power. The Commission should reject these unjustified pleas for special treatment. It should establish cable's allowed rate of return according to the same principles historically used for telephone companies.

To determine the appropriate rate of return for the cable industry, the Commission should use the cost-of-capital approach -- the methodology commonly employed by federal and state regulatory agencies and historically applied to telephone companies. As we urged in our initial comments,[46] the Commission should determine cable's cost of capital on the basis of the industry's actual capital structure and actual cost of debt, both of which are readily discernible. Dr. Vander Weide's analysis shows that cable's actual capital structure is approximately 86% debt and 14% equity; its actual

[46] Joint Comments of Bell Atlantic, et al. (Joint Comments) at 26-29.

cost of debt is approximately 7.8%.[47] Because it would be difficult to determine cable's actual cost of equity, the Commission should look to the third quartile of the S&P Industrials as an appropriate surrogate with similar investment risks. The firms in that category have an average cost of equity of 15.11%.[48]

The Commission's proposals to impute to cable the capital structure, debt costs, and equity costs of the full S&P Industrials or to impute a 50/50 debt-to-equity ratio would produce excessive returns. Because cable is highly leveraged and enjoys relatively low debt costs, using average S&P Industrials figures or imputing a 50/50 debt-to-equity ratio would give the industry a return on equity of between 32 and 37%.[49] It would be improper for the Commission to ignore the available data and impute numbers that are known to produce exorbitant investment returns.

The economic analyses submitted by cable make no serious effort to determine an average capital structure for the industry. They simply note that different operators have a variety of capital structures and then suggest that the

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[47] Affidavit of James H. Vander Weide ¶¶ 6-7 (attached to Joint Comments).

[48] Id. ¶¶ 11-13. The third quartile of the S&P Industrials is an appropriate surrogate for determining cable's cost of equity only insofar as the Commission uses cable's actual capital structure. If the Commission imputes a 50/50 capital structure, it should use a surrogate with lower costs of equity, such as the 11.80% earned by the first quartile of the S&P Industrials. Id. ¶ 21.

[49] Id. ¶¶ 14-15.

Commission adopt a 50/50 debt-to-equity ratio.[50] Cable undoubtedly recognizes that a 50/50 capital structure would produce excessive returns on equity, would inflate the overall regulated rate of return far out of line with cable's actual cost of capital, and would give cable an artificial advantage in the capital markets. There is no support in fact, and no justification in theory, for imputing to cable a 50/50 debt structure that does not even closely approximate the industry's actual capital structure and that produces harmful competitive and rate distortions.

Dr. Vander Weide calculated an actual capital structure for cable of 86% debt using Compustat data for the six largest cable operators for which information is publicly available. As Dr. Vander Weide's affidavit explains, the use of this sample is appropriate for several reasons.[51] Certainly, cable cannot reasonably claim that that the resulting figure is invalid because it did not include other, smaller cable companies. If anything, many of the smaller cable companies not included in the sample have a higher debt ratio than the sample of largest companies. Because debt is cheaper than equity, including those smaller companies would

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[50] See AUS Consultants at 8-10 (attached to Comcast Comments); Pitsch Communications at 10-11 (attached to Comments of Community Antenna Television Association, Inc. (CATA)).

[51] Dr. Vander Weide explained that the largest multiple system operators serve a high percentage of the nation's cable subscribers, that many of the remaining systems are small operations for which extensive filing requirements would be burdensome, and that many cable systems are privately held and do not publish their financial data. Vander Weide Aff. ¶ 9.